

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Johnson Analyst: Marion Mann DeJong Bill Number: SB 1014  
Related Bills: See Legislative History Telephone: 845-6979 Amended Date: 04/16/2001  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Apportionment of Business Income/1- Factor Formula-Sales Only/Extractive Businesses  
May Elect 1- or 3-Factor Formula

### SUMMARY

This bill would:

- change the apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales, and
- allow extractive businesses to choose either the current three-factor formula based on property, payroll, and sales, or use the new single-factor formula.

### SUMMARY OF AMENDMENTS

The April 16, 2001, amendments deleted the provisions of the bill as introduced and replaced them with the provisions discussed in this analysis.

### PURPOSE OF THE BILL

The purpose of the bill appears to be to attract investment to the state by lowering state income taxes for companies with substantial investment in property and payroll in California relative to sales.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendments are provided to resolve the implementation considerations. See "Implementation Considerations" below.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Gerald H. Goldberg

06/28/01

## **ANALYSIS**

### **FEDERAL/STATE LAW**

Under existing federal law, corporations organized in the U.S. are taxed on all their income, regardless of source, and are allowed a credit for any taxes paid to a foreign country on their foreign source income. Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The general apportionment formula, applicable to most corporations, takes into account property, payroll, and double-weighted sales factors. Each factor is the ratio of in-state activity to that same activity worldwide. The sum of the factors then is divided by four to obtain the taxpayer's apportionment percentage.

For corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors — property, payroll, and single-weighted sales.

Business income is multiplied by the apportionment percentage to determine the amount of income apportioned to this state for tax purposes.

### **THIS BILL**

This bill would replace the apportionment formula used by most corporations with a single-factor apportionment formula based on sales. Only corporations that derive more than 50% of their gross business receipts from extractive activities would be allowed to use a different formula. Such extractive businesses could choose either the single factor formula or the three-factor, single-weighted sales formula.

### **IMPLEMENTATION CONSIDERATIONS**

This bill would delete definitions that are needed for determining whether more than 50% of gross business receipts are derived from extractive activities. Amendments are provided to reinsert the definition of "apportioning trade or business," and to reinsert rules for combined reporting groups.

## LEGISLATIVE HISTORY

AB 1642 (Harman, 2001/2002) is identical to this bill. AB 1642 is in the Assembly Revenue and Taxation Committee.

## PROGRAM BACKGROUND

Prior to 1993, California law strictly conformed to the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll, and sales. Each factor is the ratio of in-state activity to that same activity everywhere.

In 1993, California law was amended to double-weight the sales factor. However, certain taxpayers engaged in extractive and agricultural businesses were adversely impacted and objected. To resolve this issue, those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business are provided an exception to the use of the double-weighted sales factor and are instead required to use a single-weighted sales factor in the apportionment formula.

In 1994, the exception to the use of the double-weighted sales factor was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represent a more significant contribution to a taxpayer's net income than the other two factors. Incidentally, double-weighting the sales factor shifts some tax burdens to companies with large sales in California relative to their investment in property and payroll, and reduces the tax burdens of corporations that have made substantial investment in property and payroll in California relative to sales.

## OTHER STATES' INFORMATION

*Florida, Massachusetts, Michigan, Minnesota, and New York* all use an apportionment formula based on property, payroll, and sales. The sales factor is more heavily weighted than the other two factors for all of these states as indicated in the table below. For years ending during 2001 and thereafter, *Illinois* uses an apportionment formula based entirely on sales. Some of these states provide special apportionment formulas for specific industries. *Massachusetts* uses an apportionment formula entirely based on sales for defense contractors, manufacturers, and mutual fund service corporations. The laws of these states were reviewed because of similarities to California's income tax laws.

	Property Factor	Payroll Factor	Sales Factor
California	25%	25%	50%
Florida	25%	25%	50%
Illinois	--	--	100%
Massachusetts	25%	25%	50%
Michigan	5%	5%	90%
Minnesota	12.5%	12.5%	75%
New York	25%	25%	50%

## **FISCAL IMPACT**

This bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of SB 1014 As Amended April 16, 2001 Effective for income years BOA 1/1/2001 Enacted after 6/30/2001 \$ Millions		
2001-02	2002-03	2003-04
-\$161	-\$198	-\$213

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The revenue impact of this proposal would depend on the change in tax liabilities from the proposed apportionment formula as compared to the current formula.

Samples of corporate tax returns for the tax years 1995, 1996, 1997, and 1998 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formulas were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. The revenue impact of the proposed formula was computed as the average of the above four estimates. The estimated impact was extrapolated into future years using the Department of Finance projection of corporate revenues.

## **LEGAL IMPACT**

There have been some concerns expressed in tax literature that a single-factor formula might be unconstitutional if done with the intent to benefit local commerce. In general, a single-factor sales formula would benefit companies that are physically located in one state to the detriment of those located outside that state. An equally weighted three-factor formula is the bench mark to measure distortion, while a single-factor formula is more readily subject to distortions in the market and therefore more likely to be subject to litigation.

## **ARGUMENTS/POLICY CONCERNS**

Current law provides an exception to the use of the double-weighted sales factor for corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities.

These corporations are instead required to use a single-weighted sales factor in the apportionment formula because of the adverse impact on those industries by formula that weighs sales more heavily than other factors. This bill provides an exception to the single-weighted sales formula only for extractive corporations.

Taxpayers that made a water's-edge election are bound by that election for seven years. Water's edge taxpayers would be bound by the new apportionment formula for the remainder of the election period regardless of whether they were adversely impacted by the change in the apportionment formula, unless the FTB permits a taxpayer to terminate an election under the water's edge regulations.

"Guide to State Corporate Income Tax Apportionment – Part I," by James K. Smith (*Journal of Taxation*, Vol. 19, No. 1, Summer 2000) discusses the trend by states to increase the weight of the sales factor in apportionment formulas. According to the article, proponents of increasing the weight of the sales factor claim that a more heavily weighted sales factor will increase economic development within a state, is necessary to prevent property and payroll from leaving the state, and is more constitutionally sound than other tax incentives. Opponents of a more heavily weighted sales factor claim the altered apportionment formulas only result in short-term advantages to the state, unfairly create corporate winners and losers, and do a poor job of measuring the state's contribution to a corporation's income.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1014  
As Amended April 16, 2001

AMENDMENT 1

On page 3, after line 15, add the following:

(3) "Apportioning trade or business" means a distinct trade or business whose business income is required to be apportioned under Sections 25101 and 25120, limited, if applicable, by Section 25110, using the same denominator for each of the applicable payroll, property, and sales factors.

(4) In any case where the income and apportionment factors of two or more corporations are required to be included in a combined report under Section 25101, limited, if applicable, by Section 25110, both of the following apply:

(A) The application of the more than 50 percent test of subdivision (b) shall be made with respect to the "gross business receipts" of the entire apportioning trade or business of the group.

(B) The entire business income of the group shall be apportioned in accordance with either subdivision (a) or (b) as applicable.